United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-7633

United States Court of Appeals

FOR THE SECOND CIRCUIT

THE EXCHANGE NATIONAL BANK OF CHIC

Plaintiff-Appellee,

—against—

TOUCHE ROSS & Co.,

Defendant-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR APPELLANT

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BRIEF FOR APPELLANT

Preliminary Statement

The order appealed from (A224-A225), and the underlying endorsed menorandum decision (A223), were rendered by the Honorable Inzer B. Wyatt, District Judge. The endorsed memorandum decision has not been reported.

Statement Of Issues For Review

1. Where a commercial bank such as plaintiff here makes a commercial loan to a brokerage firm, are promissory notes taken by the bank to evidence the commercial loan transaction "securities" within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934?

If such promissory notes are not "securities", does not the District Court lack subject matter jurisdiction under those statutes of claims that defendant's allegedly improper conduct caused plaintiff to enter into the commercial loan transaction, to acquire the promissory notes as a part thereof, and to suffer loss on account thereof?

3. Did not the District Court err in holding that the promissory notes upon which are based plaintiff's claims here, and which evidence the commercial loan transaction by plaintiff, are "securities" and that the District Court therefore has subject matter jurisdiction here?

Statement Of The Case

A. This Appeal.

This is an appeal, pursuant to Section 1292(b) of the Judicial Code, from an order (A224-A225) of the United States

District Court for the Southern District of New York (Wyatt, D.J.) entered on October 17, 1975, to the extent that such order denied a motion of defendant-appellant Touche Ross & Co. ("defendant Touche Ross") to dismiss the complaint and this action for lack of subject matter jurisdiction. The ground for the motion was that subject matter jurisdiction is lacking here because the three promissory notes which are the basis of the claims of plaintiff-appellee The Exchange National Bank of Chicago ("plaintiff Exchange Bank") arose out of and evidence a commercial loan transaction and therefore are not "securities" within the meaning of the Securities Act of 1933 (the "1933 Act") or the Securities Exchange Act of 1934 (the "1934 Act"), the statutes under which plaintiff Exchange Bank here sues.

B. The Nature Of The Case And The Course of Proceedings.

This action was commenced in May 1974 in the United States District Court for the Northern District of Illinois (A17). In or about January 1975, on motion of defendant Touche Ross, the action was transferred to the Southern District of New York pursuant to Section 1404(a) of the Judicial Code (A17).

The complaint in this action, which is more fully described hereinafter, asserts claims under the 1933 Act and the 1934 Act, and pendent common law claims of negligence and gross negligence. Those claims arise out of a commercial loan made in mid-1972 by plaintiff Exchange Bank to a brokerage firm ("Weis") then named Weis, Voisin & Co., Inc. and promissory notes of Weis which plaintiff Exchange Bank acquired to evidence the loan transaction, and which are alleged to have become worthless by reason of the forced liquidation of Weis commencing in May 1973. The complaint seeks to recover from defendant Touche Ross damages thereby allegedly resulting to plaintiff Exchange Bank, on the basis of assertions that plaintiff Exchange Bank made the loan to Weis and acquired the promissory notes in reliance upon conduct of defendant Touche Ross -- which is alleged to be a "public accounting firm" and to have been the "independent auditor for Weis" (A3, A4) -- allegedly in violation of the 1933 Act, the 1934 Act, Rule 10b-5 and other rules and regulations thereunder, and allegedly also constituting negligence and gross negligence.

In May 1975, prior to answer, and before any discovery, defendant Touche Ross moved -- by the motion which leads to this appeal -- to dismiss the complaint and this

action (A15). The motion sought, as already noted and pursuant to Rule 12(b), F.R Civ.P., dismissal for lack of subject matter jurisdiction. The motion also sought dismissal on other grounds pursuant to Rules 9(b) and 12(b).

The motion to dismiss was generally addressed to the face of the complaint, and generally assumed for its purposes the truth of the factual (but not the conclusory) allegations therein. However, since the three promissory notes here involved are of critical importance, and since they were not annexed to the complaint, it was necessary for defendant Touche Ross to go beyond the complaint to the extent of submitting as part of its moving papers copies of the notes themselves (A24-A50; see also A18-A19). The notes, of course, are not only part of, but their specific terms also reveal, the financial context of the loan transaction, it being that financial context which determines whether the notes evidence simply a commercial loan and therefore are not "securities" within the meaning of the 1933 Act and the 1934 Act.

In opposing the motion, plaintiff Exchange Bank itself recognized the crucial importance of the promissory notes and their terms, by also submitting copies

thereof as part of its opposing papers (A90-A116). Under the guise of examining the financial context of the loan transaction with Weis, plaintiff Exchange Bank also submitted affidavits (A51 et seq., A127 et seq.) which went well beyond the allegations of the complaint and the terms of the notes. Those affidavits are largely conclusory (seeking, like the complaint, to establish that the notes are "securities" simply by constant reference to the loan in such conclusory terms as "investment opportunity" and "investment"), and rely upon subjective and other factors which, as shown hereinafter, are in substantial part irrelevant, and in any event do not operate to make the loan transaction anything other than a commercial loan arrangement or to make the notes "securities".*

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* As defendant Touche Ross pointed out to Judge Wyatt (A219), "most of the matters upon which plaintiff Exchange Bank purports to rely [in its opposing affidavits] are peculiarly within its own knowledge, and . . . involve in large portion conversations and states of mind with respect to which defendant Touche Ross was not a party and had no prior knowledge". Under any circumstances, therefore, the assertions in plaintiff Exchange Bank's affidavits cannot be binding upon defendant Touche Ross for any future proceedings in this action. It is also to be noted that defendant Touche Ross suggested (A220) that discovery be permitted with respect to the jurisdictional issue, so that a full record could be made for determination thereof. Of course, none of the foregoing should be regarded as detracting from the position of defendant Touche Ross that its motion should have been granted, and Judge Wyatt's October 17 order should be reversed, because nothing in the complaint or the opposing affidavits overcomes the showing that the notes here are not "securities".

Judge Wyatt in his endorsed memorandum decision dated October 3, 1975,

> "denied [the motion] as to subject matter jurisdiction on the ground that the transaction seems more in the character of an investment than of a commercial loan",

but nevertheless expressly recognized that even in his own mind

> "the question is a close one and should be reviewed by the Court of Appeals before the case is prepared for trial and tried. I will therefore make the statement of 28 U.S.C. §1292(b)" (emphasis added) (A223).

With respect to the other branches of the motion, Judge Wyatt "denied [it] without prejudice to renewal" (A[illegible]).

Judge Wyatt's order of October 17, 1975, which is the order here appealed from, implemented the endorsed memorandum decision (A224-A225). The October 17 order contained the necessary certification under Section 1292(b), and stayed proceedings pending determination of this appeal (A225).

In accord with the Section 1292(b) certification granted by Judge Wyatt, defendant Touche Ross sought this Court's leave to appeal from the October 17 Order. This Court entered an order granting such leave on November 11, 1975 (A227).

Statement Of The Facts

A. Generally.

In or about July 1972, plaintiff Exchange Bank, a "national banking association" and a commercial bank in the business of making commercial loans (A3, A54), made a loan of $890,750 to Weis, and took in return three promissory notes aggregating $1,000,000 in principal amount (A9, A57). In May 1973, Weis (then operating under the name Weis Securities, Inc.) was suspended from the New York Stock Exchange, and ceased to do business. On May 30, 1975, a Trustee was appointed by the United States District Court for the Southern District of New York to liquidate Weis pursuant to legislation establishing the Securities Investor Protection Corporation ("SIPC") (A4).

With Weis now being defunct, and the three promissory notes allegedly worthless, plaintiff Exchange Bank seeks in this action to recover its losses on the notes from defendant Touche Ross (A58, A127).

B. The Complaint.

Plaintiff Exchange Bank asserts four separate counts in its complaint. Jurisdiction of those counts is alleged to be "based upon the [1933 Act], the [1934 Act], the General Rules and Regulations thereunder, and the principle of pendent jurisdiction" (A3).

Count I charges defendant Touche Ross with violations of Section 17(a) of the 1933 Act, Section 10(b) of the 1934 Act, and Rule 10b-5 and other rules and regulations thereunder. It alleges that on July 7, 1972, defendant Touche Ross issued opinions with respect to certain Weis financial statements dated as of May 26, 1972, and that in reliance thereon plaintiff Exchange Bank agreed to and did make the loan of $890,750 to Weis (A4-A7, A9). Although plaintiff is a commercial bank, and although its loan to Weis was clearly a commercial loan, Count I attempts to bring the loan within the coverage of the 1933 Act, the 1934 Act and Rule 10b-5 by the simple expedient of characterizing the promissory notes evidencing the loan as "securities", and seeks to buttress that characterization by talking of the making of the loans as "purchases" and of plaintiff Exchange Bank as an "investor" (A5, A9).

Count I then alleges, in order to establish liability on the part of defendant Touche Ross, that the Weis financial statements upon which plaintiff Exchange Bank relied were materially false and misleading in various respects, and that defendant Touche Ross "knew or should have known" of the alleged misstatements contained therein (A7-A8). Finally, Count I purports to establish damage to plaintiff Exchange Bank by alleging that in May 1973 (long after plaintiff Exchange Bank made its loan to Weis), Weis "was placed in SIPC receivership" and "is now being liquidated", and that the Weis "securities" purchased by plaintiff Exchange Bank are now "worthless" (A9).*

Count II of the complaint incorporates by reference the material allegations of Count I, and adds the conclusory allegation that "[i]n connection with the transactions

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* Subsequent to the commencement of the Weis liquidation by the SIPC Trustee, on March 19 and May 29, 1974, respectively, Arthur J. Levine and Sol Leit, the Weis officers who allegedly negotiated the loan with plaintiff Exchange Bank, pleaded guilty to Count I of an indictment (United States of America v. Levine, et al., S.D.N.Y. 73 Cv. 693) which count accused them of, inter alia, having kept fraudulently books of account and financial records, and which also alleged that Levine, Leit and others "did fraudulently conceal from Weis' auditors, Touche Ross & Co., the existence and nature of the aforesaid fraudulent books and records and, in addition, . . . did create directly and indirectly wholly fictitious documentation for the aforesaid fraudulent entries" (emphasis added) (A21-A22). Levine and Leit were also defendants in an action for a permanent injunction commenced by the Securities & Exchange Commission against Weis and its officers. Neither the indictment nor the SEC complaint, which was filed after an extensive and thorough investigation by the SEC, charge defendant Touche Ross with any wrongdoing whatsoever (A21).

described [in Count I] and the filing with the [SEC] of Weis' [financial statements]", defendant Touche Ross made "false and misleading" statements in "violation of Section 18(a)" of the 1934 Act (A10).

Count III again repeats preceding allegations and then alleges that the conduct of defendant Touche Ross in making its audit examination and rendering its opinions with respect to the Weis financial statements constituted common law negligence and gross negligence (A11). Since Count III is a common law count, and since there is clearly no diversity of citizenship here (see A3 (¶¶1, 2)), subject matter jurisdiction is necessarily pendent, and depends upon the existence of subject matter jurisdiction over the other counts.

Count IV also repeats the preceding allegations, and then alleges in conclusory language that Weis itself violated various provisions of the 1934 Act and the rules thereunder; that defendant Touche Ross "knew or should have known" of such alleged violations and that its audit examination and opinions with respect to the Weis financial statements "would and did give substantial assistance and encouragement" to those alleged violations; and that defendant Touche Ross is therefore liable for "aiding and abetting" Weis' alleged violations (A12-A13).

C. The Promissory Notes.

The three promissory notes upon which the complaint is based and which evidence the loan by plaintiff Exchange Bank to Weis are set forth in the Appendix at pages 24-50 and also at pages 90-116. The notes were the result of face to face negotiations in or about July 1972 in Chicago (presumably at the offices of plaintiff Exchange Bank) between the Chairman of the Board (Arthur J. Levine) and the President (Sol Leit) of Weis, on the one hand, and the Executive Vice President (Melvin K. Lippe) of plaintiff Exchange Bank (A52).

Examination of the notes themselves makes clear that they evidence a commercial loan transaction, and not a "security" or an "investment".

For example, the three notes -- which are all dated July 31, 1972 and which are in the respective face amounts of $500,000, $250,000 and $250,000 (A24, A33, A42; see also A90, A99, A108) -- were each payable as to principal amount on a specified date within an 18-month period or at a later date at the option of plaintiff Exchange Bank. Thus, the principal amounts of the notes were payable, respectively, on July 31, 1973, October 31, 1973 and January 31, 1974, or "upon such date thereafter as may be specified by [plaintiff Exchange Bank] upon written demand

received by [Weis] at least six months prior to the payment date so specified" (emphasis added) (A24, A33, A42; see also A90, A99, A108).

Moreover, interest was paid and payable on the promissory notes just as on an ordinary commercial loan. Indeed, interest was payable on the notes after the respective dates of July 31, 1973, October 31, 1973 and January 31, 1974 at a rate tied not to any investment considerations but expressly to the "commercial loan rate". Thus, each of the promissory notes expressly provided that such interest was to be paid "at a rate per annum . . . which shall be 3% in excess of the prime commercial loan rate of [plaintiff Exchange Bank] then in force for short-term borrowings, but in no event less than 9% per annum" (emphasis added) (A24, A33, A42; see also A90, A99, A108).

Plaintiff Exchange Bank had also extracted in advance interest for the periods up to the respective dates of July 31, 1973, October 31, 1973 and January 31, 1974, by discounting the face amounts of the promissory notes. Thus, plaintiff Exchange Bank received the notes, which are in an aggregate principal amount of $1,000,000, in exchange for a loan in the aggregate amount (characterized by the complaint as "a price") of $890,750, the proceeds

of which were paid to Weis on August 7, 1972 (A9, A57). The proceeds of the loan reflected a discount from the aggregate principal amount of the loans and the notes evidencing them, that discount clearly having been the interest on the loans up to the interest dates specified in the notes.

In addition to the fact that the three promissory notes on their faces expressly tie the rate of interest thereon to the "prime commercial loan rate" of plaintiff Exchange Bank (A24, A33, A42; see also A90, A99, A108), and the fact that plaintiff Exchange Bank concededly is a commercial lender which makes commercial loans (A54), the three notes do not possess any of the characteristics usually associated with investment securities. For example, and as more fully discussed hereinafter (pp.28-38, infra),

(i) Weis' obligations to repay the notes were unconditional, and neither repayment of the principal nor payment of interest was contingent in any way upon Weis' activities or on Weis' profits;

(ii) The loan was to aid Weis' business operations and plaintiff Exchange Bank had no expectation of participating in profits of Weis or of receiving significant benefits extrinsic to repayment of the loan;

(iii) The notes were not offered to the general public or outside the commercial loan market;

(iv) The notes did not give plaintiff Exchange Bank the right to vote under any circumstances or any control over the operations and affairs of Weis;

(v) Weis did not obtain investment assets, directly or indirectly, in exchange for the notes;

(vi) The transaction giving rise to the notes was not of the kind in which stock or similar securities are usually issued; and

(vii) The notes did not have any of the attributes of investment securities as set forth by the "functional" definition contained in Section 8-102(1) of the Uniform Commercial Code.

In opposing defendant Touche Ross' motion to dismiss, plaintiff Exchange Bank sought to show -- and the District Court erroneously found -- that, despite the foregoing commercial loan characteristics of the notes, the notes reflected an investment transaction and therefore were "securities". The factors upon which plaintiff Exchange Bank purported to base that showing, and which apparently were relied upon (erroneously, defendant Touche Ross contends) by the District Court, included its assertions,

for example, that

(i) The loan was subordinated to claims of general creditors of Weis (A54-A55);

(ii) A substantial number (said to be 51) of other lenders held notes or interests similar to those held by plaintiff Exchange National Bank (A54, A130);

(iii) The notes held by plaintiff Exchange Bank could be transferred or prepaid only with the approval of the New York Stock Exchange ("NYSE"), pursuant to NYSE Rule 325 (A55);

(iv) Pursuant to NYSE Rule 325, the loans were allegedly listed on Weis' financial statements under the heading "Subordinated Liabilities and Stockholders' Equity", and were includible within Weis' "net capital", as that term is defined in NYSE Rule 325 (A131); and

(v) The motivation of plaintiff Exchange Bank in making the loans to Weis allegedly was, in

addition to receiving repayment of principal and interest, the expectation that Weis and its customers would use the Tel Aviv, Israel branch of plaintiff Exchange Bank as a depositary for funds (A53).

Each of the factors relied upon by plaintiff Exchange Bank is hereinafter analyzed (pp. 39-46 , infra) to demonstrate that none of them alters the "commercial loan" character of the notes so as to make them "securities" for purposes of the 1933 Act and the 1934 Act.

Argument

I

PROMISSORY NOTES ACQUIRED IN THE CONTEXT OF A COMMERCIAL LOAN TRANSACTION ARE NOT "SECURITIES" UNDER THE 1933 ACT AND THE 1934 ACT, AND THOSE STATUTES DO NOT CONFER SUBJECT MATTER JURISDICTION OVER CLAIMS WITH RESPECT TO SUCH NOTES

A. Subject Matter Jurisdiction Here Is Based Upon The 1933 Act And The 1934 Act, And Depends Upon Whether The Promissory Notes Held By Plaintiff Exchange Bank Are "Securities".

Subject matter jurisdiction over the federal claims asserted in Counts I, II and IV of the complaint is premised upon the provisions of the 1933 Act and the 1934 Act (A3).

Moreover, since the complaint shows on its face a lack of diversity of citizenship (A3), subject matter jurisdiction over the common law claims in Count III of the complaint is alleged to be pendent (A3). Thus, absent a valid jurisdictional basis under the 1933 Act or 1934 Act, the District Court would lack subject matter jurisdiction over all the counts of the complaint herein.

It is elementary that the 1933 Act and the 1934 Act extend only to transactions involving "securities". Thus, Section 10(b) of the 1934 Act and Rule 10b-5 thereunder relate only to acts or omissions "in connection with the purchase or sale of <u>any security</u>". Similarly, Section 17(a) of the 1933 Act and Sections 15(c) and 18(a) of the 1934 Act speak only of transactions involving "securities" or "a security". Consequently, if the promissory notes which are the basis of plaintiff Exchange Bank's alleged federal claims are not "securities" (and, as shown hereinafter, they are not), there is no subject matter jurisdiction here.

B. <u>In Determining Whether Promissory Notes Are "Securities", The Financial Context Governs.</u>

Both the 1933 Act and 1934 Act explicitly recognize that in determining whether an instrument is a "security" within

the meaning of those Acts the financial context of the transaction giving rise to the instrument is of critical importance. Thus, the definition, in Section 3(a)(10) of the 1934 Act, including certain notes within the definition of a security is expressly subject to the qualification "unless the context otherwise requires", as follows:

> "3. (a) . . . unless the context otherwise requires -
>
> ". . .
>
> "(10) The term 'security' means any note . . . but shall not include . . . any note . . . which has a maturity at the time of issuance of not exceeding nine months" (emphasis added). 15 U.S.C. §78c(a)(10).

The 1933 Act contains a substantially similar definition, with the same "unless the context otherwise requires" language, in Sections 2(1) and 3(a)(3) thereof. 15 U.S.C. §§77b(1), 77c(3).

Moreover, as the Supreme Court recently emphasized in rejecting the so-called "literal" approach to the definition of a "security",

> "Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto. Thus, in construing these Acts against the background of their purpose, we are guided by a traditional canon of statutory construction: '[A] thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers'" (emphasis added). United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975).

C. Promissory Notes Issued In The Context Of A Commercial Loan Transaction Are Not "Securities".

In applying the cardinal rule that the statutory definition of a "security" is to be applied only if the context does not otherwise require, it has been clearly recognized that the maturity of a note is not determinative, and that the financial context of the transaction -- that is, whether in light of the specific terms of the note and other pertinent factors the note constitutes investment paper as opposed to commercial paper -- is the crucial factor. Thus, in Zeller v. Bogue Electric Mfg. Corp., 476 F.2d 795, 800 (2d Cir.), cert. denied, 414 U.S. 908 (1973), this Court held that

> "[T]he mere fact that a note has a maturity of less than nine months does not take the case out of Rule 10b-5, unless the note fits the general notion of 'commercial paper'. . . . It does not follow . . . that every transaction within the introductory clause of [Section 3 (a)(10) of the 1934 Act], which involves promissory notes, whether of less or more than nine months maturity, is within Rule 10b-5. The Act is for the protection of investors, and its provisions must be read accordingly" (emphasis added).

Recognizing that the purpose of the securities acts is the protection of investors (as opposed to ordinary commercial lenders), numerous Courts have held that notes which are issued in the context of a commercial loan transaction are not "securities" and therefore fall beyond the purview of the federal securities acts.

For example, in Bellah v. First Nat'l Bank of Hereford, 495 F.2d 1109 (5th Cir. 1974), the Fifth Circuit held that a six-month promissory note, secured by a deed of trust on real property and issued for a bank loan needed by the makers to aid them in the development of their livestock business, was not a "security". The Court held that subject matter jurisdiction under the 1934 Act "hinges upon whether the note . . . can be characterized as commercial or investment in nature", and then went on to state that

> "the note issued by the Bellahs in this case was commercial paper and not investment paper. The record reveals that in extending the loans, the Bank merely intended to aid the Bellahs in the operation of their livestock business. It is bereft of any evidence indicating that the Bank sought to profit from the successful operation of this enterprise. . . . We merely hold that notes issued in the context of a commercial loan transaction fall beyond the purview of the Act.
>
> ". . . [T]he Securities Act of 1933 and the Securities Exchange Act of 1934 create for participants in note transactions a broad but nevertheless not boundless federal forum for vindicating their grievances. We doubt that Congress intended by these Acts to render federal judges the guardians of all beguiled makers or payees. Where, as here, complaints are spawned by a commercial loan transaction, recourse must be had to state not federal courts" (emphasis added). 495 F.2d at 1113-1114.

Similarly, in McClure v. First Nat'l Bank of Lubbock, 497 F.2d 490 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975),

the Fifth Circuit held that a one-year promissory note evidencing a loan made for the ostensible purpose of paying corporate obligations of a closely-held corporation was not a "security". The Court pointed out that

> "Although the Securities Exchange Act of 1934 provides that the term security means 'any' note, judicial decisions have restricted the application of the Act to those notes that are investment in nature and have excluded notes which are only reflective of individual commercial transactions",

that

> 'where notes have been deemed securities within the meaning of the securities laws, either of two factors, not present here, usually indicated the investment overtones of the underlying transactions. . . . [The notes were either] offered to some class of investors, [or] were . . . acquired by the Bank for speculation or investment . . . [or the borrower obtained] investment assets, directly or indirectly, in exchange for its notes",

and that

> "On one hand, the [1934] Act covers all investment notes, no matter how short their maturity . . . . On the other hand, the [1934] Act does not cover any commercial notes, no matter how long their maturity, because they fall outside the 'any note' definition of a security" (emphasis added). 497 F.2d at 492, 493-495.

Likewise, in C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), cert. denied, 44 U.S.L.W. 3201 (1975), the Seventh Circuit dismissed for lack of subject matter jurisdiction an action involving notes given by a bank in what analysis showed to be a commercial, and not an investment,transaction. After reviewing the statutes and the cases and the "basis for the commercial-investment dichotomy", the Court stated that

> "the application of the rule is not difficult in this case.
>
> ". . . The $20,000 note secured by a chattel mortgage was given to the National Bank of Austin as evidence of a loan. The $73,515.26 note was given to the Austin Bank upon the assumption by the makers of a pre-existing chattel mortgage on the fixtures of the coin-operated laundry and dry cleaning business which the makers purchased. . . . [N]othing alleged in the complaint indicated that these two notes represent anything beyond the borrowing of money to make partial payment upon the purchase of the assets of a business.
>
> "Nothing alleged in the complaint indicated in any way that the bank was an investor in the business or a co-partner in the enterprise. The impetus for the transaction appears to have come from the borrowers who needed cash to complete the purchase. There is no allegation that the bank solicited the plaintiffs to interest them in an investment. The business enterprise involved was to be operated by the plaintiffs, not by the bank or by the defendants as an investment for the plaintiffs. The complaint was

> silent as to any of the factors which conceivably might tend to transform an ordinary commercial loan into an investment security" (emphasis added). 508 F.2d at 1362-1363.*

Avenue State Bank v. Tourtelot, 379 F.Supp. 250 (N.D. Ill. 1974), and Thorp Commercial Corp. v. Northgate Industries, Inc., CCH Fed.Sec.L.Rep. ¶94,929 (D. Minn. 1974), were actions by a bank and a commercial finance company, respectively. In each case the plaintiff alleged that it had been induced to lend funds in exchange for a promissory note or notes as the result of fraudulent misrepresentations concerning the financial condition of the borrower, and that such fraud violated the federal securities acts. In dismissing the action for lack of subject matter jurisdiction in Avenue State Bank, the Court noted that

> "[T]he issue in this case is simply whether the borrowing of money in an ordinary commercial bank loan transaction . . . and the giving of a promissory note to evidence the indebtedness . . . constituted the 'sale' of a 'security'",

and that

> "It is our belief, and we think that a close analysis and criticism of judicial precedents supports our view, that even a

* In United Housing Foundation, Inc. v. Forman, supra, the Supreme Court cited with approval the approach taken by the Fifth and Seventh Circuits, respectively, in McClure v. First Nat'l Bank of Lubbock, and in C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc. 421 U.S. at 849 n. 14.

> required broad interpretation of the definition of security should not include the type of ordinary bank transaction presented for our consideration here" (emphasis added). 379 F.Supp. at 252-253.

And in Thorp Commercial Corp., the Court dismissed the securities claim for failure to state a claim for which relief could be granted, holding the "commercial/investment dichotomy" to be determinative, and stating that

> "The commercial or investment character of promissory notes can be determined only from examination of the total transaction. Critical elements of investment notes are: (1) the payee-lendor's expectation of participating in the profits of the maker-borrower, or of receiving substantial benefits from the maker's success extrinsic to the direct return on the loan, and (2) the maker's offering its notes to investors. . . .
>
> "The present complaint does not in any way suggest that either of the critical elements of an investment are to be found in the transaction at issue. The Federal securities laws are not intended to protect banks and finance companies from fraud by a borrower in an ordinary commercial loan transaction. These institutions must turn to State law for relief" (emphasis added). CCH Fed. Sec. L. Rep. ¶94,929 at pp.97,212-97,213.

See also United States v. Koenig, 388 F.Supp. 670, 714 (S.D.N.Y. 1974)("the better cases . . . have recognized context-over-text and . . . held that the note must evidence a loan which was

given for investment purposes and not for ordinary commercial loan purposes"); Rosen v. Dick, CCH Fed.Sec.L.Rep. ¶94,786, p. 96,605 (S.D.N.Y. 1974); Oxford Finance Cos. Harvey, 385 F.Supp. 431 (E.D. Pa. 1974).

In addition to the statutory "unless the context otherwise requires" language, and the statutory purpose of the federal securities laws to protect investors, the courts have noted that there are other reasons for the exclusion of notes evidencing commercial loans from the concept of a "security". Thus, for example, in Zabriskie v. Lewis, 507 F.2d 546, 551 (10th Cir. 1974), the Tenth Circuit referred to "the practical considerations of subjecting commercial notes to the registration provisions of the Securities Acts as well as fear of the resulting litigation flooding the federal courts if commercial notes were included". Similarly, in Bellah v. First Nat'l Bank, supra, the Fifth Circuit observed that "in view of the . . . similitude of the '33 and '34 Acts, notes subject to the anti-fraud proscriptions of the latter would be amenable to the registration provisions of the former", and pointed out that "[r]egistration is a costly procedure, both temporarily and financially speaking", which would "wreak havoc" in the commercial loan market. 495 F.2d at 1114.

* * *

The teaching of the foregoing authorities is not only that there is no subject matter jurisdiction under the 1933 Act and the 1934 Act of claims based on promissory notes which evidence a commercial loan and are therefore not "securities", but also that the holder of promissory notes, such as plaintiff Exchange Bank here, does not make them "securities" within the purview of the 1933 Act and the 1934 Act by such conclusory assertions as that the notes are "securities", that the notes were "purchased" by the loan proceeds, or that the notes were an "investment opportunity" and an "investment". Rather, what is determinative as to whether the notes are "securities" or instead simply evidence of a commercial loan is the financial context of the transaction as shown by the terms of the notes and other pertinent factors. In the present case, and as Judge Wyatt erroneously failed to recognize, the context of the transaction in which plaintiff Exchange Bank acquired its promissory notes demonstrates, and which is analyzed below, the transaction to be a commercial loan and that the notes are not "securities" within the meaning of the 1933 Act and the 1934 Act.

II

THE PROMISSORY NOTES HERE WERE ACQUIRED BY PLAINTIFF EXCHANGE BANK IN THE CONTEXT OF A COMMERCIAL LOAN TRANSACTION, EVIDENCE A COMMERCIAL LOAN, AND ARE NOT "SECURITIES"

Taking into account the allegations of the complaint, the promissory notes themselves and their terms, and the affidavits submitted by plaintiff Exchange Bank on the motion to dismiss, the pertinent factors demonstrate, as a matter of law, that the notes are not "securities" within the meaning of the 1933 Act and the 1934 Act. Those factors show, as a matter of law, that the notes were issued in the context of a commercial loan transaction, and evidence not an investment but rather simply a commerical loan made by plaintiff Exchange Bank.

Those pertinent factors, various of which have been referred to hereinabove (e.g., pp. 12-17, supra), include the following:

1. The Commercial Loan Business of Plaintiff Exchange Bank. -- Plaintiff Exchange Bank is a commerical bank which admittedly is in the business of making commercial loans. It has a "staff which handles normal commercial loans" and which includes "normal commercial loan officers", and is said to have a "normal commercial loan note" (A52, A54, A117).

Although plaintiff Exchange Bank would emphasize that the loan to Weis was negotiated on its behalf by one (Mr. Lippe) who "was not . . . part of the Bank's staff which handles normal commercial loans" and that the notes evidencing the Weis loan "differ in several significant respects from the normal commercial loan note used by [plaintiff Exchange Bank]" (A52, A54), plaintiff Exchange Bank nowhere denies that it does make commercial loans through bank personnel who are not part of its staff for handling "normal commercial loans" and does not deny that it does make commercial loans where the notes involved differ from its "normal commercial loan note" (emphasis added).* In fact, it is conceded that Mr. Lippe -- although not on the "staff which handles normal commercial loans" -- does have "contact with that aspect of the Bank's functioning" (A52).

2. The Notes Were To Be Repaid In Full. -- Each of the three promissory notes was to be repaid in full principal amount on a specified date (one note on July 31, 1973, one on

* The careful and repeated stress by plaintiff Exchange Bank on its "normal" commercial loans and its "normal" commercial loan officers and its "normal" commercial loan note permits (even on the present motion) only one inference, viz., that plaintiff Exchange Bank also makes commercial loans which are not in its "normal" pattern, such as the commercial loan to Weis which the promissory notes here clearly evidence.

October 31, 1973, and one on January 31, 1974) within 18 months after the date of the notes, or at a later date specified by and at the option of plaintiff Exchange Bank (A24, A33, A42; see also A90, A99, A108). Significantly, Weis' obligation to repay the notes was unconditional, and neither principal nor interest payments were contingent upon Weis' activities or profits. Cf., e.g., C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., supra, 508 F.2d at 1361 ("making repayment of funds contingent upon some event . . . tend[s] to indicate security rather than loan").

3. The Interest Rate Was Expressly Tied To The Rate For Commercial Loans. -- Interest was paid and payable on the promissory notes just as on any other commercial loan. Indeed, interest was payable on the notes after the respective dates of July 31, 1973, October 31, 1973 and January 31, 1974, at a rate tied not to any investment considerations but expressly to the "commercial loan rate". Thus, each of the promissory notes expressly provided that such interest was to be paid "at a rate per annum . . . which shall be 3% in excess of the prime commercial loan rate of [plaintiff Exchange Bank] then in force for short-term borrowings, but in no event less than 9% per annum" (emphasis added)(A24, A33, A42; see also A90, A99, A108).

Plaintiff Exchange Bank had also extracted in advance interest for the periods up to the respective dates of July 31, 1973, October 31, 1973 and January 31, 1974, by

discounting the face amounts of the promissory notes. Thus, plaintiff Exchange Bank received the notes, which are in an aggregate principal amount of $1,000,000, in exchange for a loan in the aggregate amount of $890,750, the proceeds of which were paid to Weis on August 7, 1972 (A9, A57). The proceeds of the loan reflected a discount from the aggregate principal amount of the loan and the notes taken to evidence it, that discount clearly having been the interest on the loan up to the interest dates specified in the notes.

4. The Loan Was To Aid Weis' Business Operations And Plaintiff Exchange Bank Was Not To Profit From Those Operations. -- The purpose of the loan to Weis was to aid Weis' business operations. Indeed, it is conceded by plaintiff Exchange Bank that "the proceeds of [the loan] were to be used to expand Weis' brokerage activities, both in the United States and abroad" (A52).* Moreover, plaintiff Exchange Bank was not to receive, and nowhere claims that it was entitled to, any interest in the business of Weis, any share of profits

* It is significant that the "normal" commercial loans of plaintiff Exchange Bank have just such a business purpose. Thus, its "normal commercial loan note" expressly provides that the borrower "represents that the sole purpose of this loan is for the carrying out of, or acquiring, a business, and that the proceeds of the loan will be used solely for such business purposes" (emphasis added)(A117). The point here is that, the purpose and substance of the Weis loan having been the same as the purpose and substance of the "normal" commercial loans made by plaintiff Exchange Bank, the Weis loan was simply a commercail loan, and to hold otherwise because the promissory notes here are in a different form than the "normal commercial loan note" would be to exalt form over substance.

derived or to be derived from the Weis business, or any other investment benefits extrinsic to repayment of the loan.

It is well-established that the business purpose of the loan and the lack of any share by plaintiff Exchange Bank in profits from Weis' business compel the conclusion that the loan to Weis was, and that the promissory notes here evidence, nothing more than a commercial loan. E.g., Bellah v. First Nat'l Bank of Hereford, supra, 495 F.2d at 1113 ("the note . . . was commercial paper and not investment paper. . . . [I]n extending the loans, the Bank merely intended to aid the Bellahs in the operation of their livestock business. [The record] is bereft of any evidence indicating that the Bank sought to profit from the successful operation of this enterprise"); McClure v. First Nat'l Bank of Lubbock, supra, 497 F.2d at 493 (a factor which "usually indicate[s] the investment overtones of the underlying transactions" is that the notes were "acquired by the Bank for speculation"); C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., supra, 508 F.2d at 1362-1363 ("[N]othing alleged in the complaint indicated that these two notes represent anything beyond the borrowing of money to make partial payment upon the purchase of the assets of a business. Nothing alleged in the complaint indicated in any way that the bank was an investor in the

business or a co-partner in the enterprise"); Zabriskie v. Lewis, supra, 507 F.2d at 551 ("[T]he fact proceeds are to be used for a business purpose, however, does not mean an investment note is involved. . . . The Bellah and McClure cases involved loan transactions within normal commercial circles and 'business purpose' notes were held to have a commercial character"); Thorp Commercial Corp. v. Northgate Industries, Inc., supra, CCH Fed.Sec.L.Rep. ¶94,929 at pp.97,212-97,213 ("[One of the c]ritical elements of investment notes [is]: (1) the payee-lendor's expectation of participating in the profits of the maker-borrower, or of receiving substantial benefits from the maker's success extrinsic to the direct return on the loan")(emphasis added).*

* In this connection, it is also significant that Weis "approached" plaintiff Exchange Bank about a loan, and that the officers of Weis "came to Chicago [where plaintiff Exchange Bank is located] to negotiate the [loan] transaction" (A3, A52). Cf., e.g., C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., supra, 508 F.2d at 1363 (a loan was a commercial loan, and not an investment transaction, where, inter alia, "[t]he impetus for the transaction appears to have come from the borrowers who needed cash. . . . There is no allegation that the bank solicited the [borrowers] to interest them in an investment" (emphasis added)); Zabriskie v. Lewis, supra, 507 F.2d at 551 ("When a prospective borrower approaches a bank for a loan and gives his note in consideration for it, the bank has purchased commercial paper.")(quoting from Sanders v. John Nuveen & Co., 463 F.2d 1075, 1080 (7th Cir.), cert. denied, 409 U.S. 1009 (1972)).

5. The Notes Were Not Offered Outside The Commercial Loan Market.-- The promissory notes here were not offered to the public generally or outside the commercial loan market. Cf., e.g., McClure v. First National Bank of Lubbock, supra, 497 F.2d at 493 (a factor which "usually indicate[s] the investment overtones of the underlying transactions" is that the notes were "offered to some class of investors"); Thorp Commercial Corp. v. Northgate Industries, Inc., supra, CCH Fed. Sec. L. Rep. ¶94,929 at pp.97,212-97,213 ("[One of the c]ritical elements of investment notes is: . . . (2) the maker's offering its notes to investors").

Plaintiff Exchange Bank does seek to suggest that Weis did offer its notes to a class of investors, but that suggestion is erroneous and must be rejected. In the first place, the suggestion is based on inadmissible hearsay testimony that, for example, officers of Weis "told [plaintiff Exchange Bank] that similar Weis notes had been purchased by other investors and that they were planning to offer similar notes to others in the future" (A54).

Moreover, the assertions that "Weis had indeed placed substantially similar notes with additional 'subordinate lenders'" (A54) and that there were "51 lenders . . . who held interests similar to plaintiff's" (A130) are just not so. This is because, as more fully discussed hereinafter (pp.41-43, infra), the obligations imposed upon Weis by the promissory

notes held by plaintiff Exchange Bank were senior to all obligations of Weis to other subordinated creditors, except for two other commercial lenders holding notes which were pari passu. Of course, while Weis clearly had more than one source for commercial loans, that fact cannot operate to convert each of its commercial loans into an "investment" transaction so as to make the note evidencing that transaction a "security".

In this connection, it is noteworthy that, prior to July 1972 (when plaintiff Exchange Bank made the loan to Weis), commercial banks had been actively seeking amendment of the New York Stock Exchange rules so as to permit, and make more attractive to the banks, increased commercial loans to brokerage firms generally. On August 4, 1972, about the time of the Weis loan itself, the New York Stock Exchange announced the adoption of an amendment to NYSE Rule 325 which was "the culmination of many months of exploration and negotiations with banks who have sought a way to become subordinated lenders to member oganizations" and pointed out that "[t]he new provisions [of Rule 325] were designed to give banks a way in which to make subordinated loans to member organizations, and its features are most likely to be attractive to banks". NYSE, M.F. Educational Circular No. 381 (August 4, 1972)(Appendix A to this brief). The amendment to

Rule 325 thus demonstrates not only that banks generally were actively seeking to expand their commercial loan business by making more commercial loans to brokerage firms, but also that subordinated commercial loans by banks to brokerage firms are neither unknown nor unusual.

6. Other Pertinent Factors. Various other factors go to show that the Weis loan was a commercial loan transaction, rather than an investment arrangement. For example, the notes did not give plaintiff Exchange Bank any right to vote with respect to or any control over or participation in the operations and affairs of Weis, under any circumstances. Cf., e.g., C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., supra, 508 F.2d at 1362-1363 (a loan was a commercial loan, and not an investment transaction, where, inter alia, "[n]othing alleged in the complaint indicated in any way that the bank was . . . a co-partner in the enterprise").

Another example is that (i) Weis did not obtain investment assets, directly or indirectly, in exchange for its promissory notes, and (ii) the transaction which gave rise to the notes was not of the kind in which stock or similar securities are usually issued. These two factors in particular make it readily apparent that the present situation differs drastically from cases such as

Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662 (2d Cir. 1971), where notes issued in exchange for the assets of a business in a transaction which was in substance a merger or acquisition were held to be "securities".

Another example is that the promissory notes here do not have any of the attributes of investment securities as set forth in the "functional" definition contained in Section 8-102(1) of the Uniform Commercial Code, which provides that

> "(1) In this Article unless the context otherwise requires (a) A 'security' is an instrument which (i) is issued in bearer or registered form; and (ii) is of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment; and (iii) is either one of a class or series or by its terms is divisible into a class or series of instruments; and (iv) evidences a share, participation or other interest in property or in an enterprise or evidences an obligation of the issuer" (See, e.g., 62 1/2 McKinney's New York Uniform Commercial Code §8-102).

The notes here were neither "issued in bearer or registered form", nor "of a type commonly dealt in upon securities exchanges or markets", nor "of a type . . . commonly recognized in any area in which [they were] issued or dealt in as a medium for investment", nor part "of a class or series or . . . divisible into a class or series of instruments". In short, the notes here lack the earmarks of a "security" as defined by the Uniform Commercial Code.

This is not meant to suggest that the Code is controlling on the issue of what constitutes a "security" within the meaning of the federal securities acts. However, as indicated in the Official Comment to Section 8-102,

> "The definition of 'security' [contained in U.C.C. §8-102] is functional rather than formal, and it is believed will cover anything which securities markets, including not only the organized exchanges but as well the 'over-the-counter' markets, are likely to regard as suitable for trading" (see 62-1/2 McKinney's New York Uniform Commercial Code, Official Comment following §8-102),

and, as the Supreme Court has observed on more than one occasion, "[t]he test . . . is what character the instrument is given in commerce". Securities & Exchange Commission v. United Benefit Life Ins. Co., 387 U.S. 202, 211 (1967), quoting Securities & Exchange Commission v. Joiner Leasing Corp., 320 U.S. 344, 352-353 (1943).

* * *

The foregoing factors demonstrate that the Weis loan was, and the promissory notes here evidence, simply a commercial loan transaction. Plaintiff Exchange Bank seeks to obscure those factors and the conclusions they compel, by relying on other purported considerations. As shown below, however, those considerations do not help plaintiff Exchange Bank.

III

THE FACTORS RELIED UPON BY PLAINTIFF EXCHANGE BANK ARE INSUFFICIENT TO SHOW THAT THE PROMISSORY NOTES HERE ARE SECURITIES

The factors upon which plaintiff Exchange Bank relies, and upon which Judge Wyatt apparently (and erroneously) relied, to show that the promissory notes here are securities have been adverted to hereinabove (pp. 15-17, supra). None of those factors, however, alters the "commercial loan" character of the notes or is sufficient to make them "securities" for purposes of the 1933 Act and the 1934 Act.

1. The Factor of Subordination. -- The principal factor relied upon by plaintiff Exchange Bank to establish that the promissory notes are "securities" is the provision of paragraph 2 of each note pursuant to which its rights to repayment of principal and interest were subordinated to claims of general creditors. However, plaintiff Exchange Bank, beyond asserting its own alleged "lack of prior experience" (A52) with such a loan transaction, makes no showing that the presence of the subordination provision removed the transaction from the various types of lending activities in which commercial lenders customarily engage. Plaintiff Exchange Bank thus does nothing to refute the obvious fact -- expressly recognized by the NYSE in adopting an amendment to the rules governing such transactions (see Appendix A hereto) -- that loans having terms

similar to those made by plaintiff Exchange Bank to Weis are simply one of the many types of loans which are made by commercial banks generally.

Plaintiff Exchange Bank's position, apparently adopted by Judge Wyatt, is that as a matter of law the presence of the subordination clause removed the notes from the commercial loan context. However, the question of whether or not subordinated loans made by commercial lenders are "securities" appears to be one of first impression. In neither of the two reported cases* dealing with the effect of a subordination provision was that provision contained in a loan made by a commercial bank. In fact, in each of those cases the subordination agreement was entered into by one or more investors with respect to loans of their actual investment securities to a broker-dealer. Thus, the financial context there clearly involved a disposition for value (i.e., a "sale") of an interest in investment securities. See Hughes v. Dempsey - Tegeler & Co., Inc., supra, at p.94,538.

Moreover, and even assuming that those two cases were correctly decided, it is nonetheless clear that a transaction by an investor with respect to his own investment assets

* Hughes v. Dempsey - Tegeler & Co., Inc., CCH Fed. Sec. L. Rep. ¶94,133 (C. D. Cal. 1973); New York Stock Exchange, Inc. v. Sloan, 394 F.Supp. 1303 (S.D.N.Y. 1975).

differs from and arises in a different context than a loan made by a commercial bank. The former situation is one which clearly requires an application of the principle that "[t]he [1934] Act is for the protection of investors and its provisions must be read accordingly". Zeller v. Bogue Electric Mfg. Corp., supra, 476 F.2d at 800. The latter situation, in contrast, merely reflects just another "type of ordinary bank transaction" falling outside of the area intended by Congress to be covered by the 1933 and 1934 Acts. Cf. Avenue State Bank v. Tourtelot, supra, 379 F.Supp. at 253. It is thus clear that the mere presence of a subordination clause does not, as plaintiff Exchange Bank would suggest, in and of itself take a bank loan out of the commercial context and transform it into an "investment".

2. The Alleged Factor Of Other Similar Notes. -- Another factor relied upon by plaintiff Exchange Bank is its contention that there were "a substantial number" (said to be 51) of others who held similar subordinated notes or interests (A54, 130). However, and as already noted (pp. 34-35, supra), the notes of plaintiff Exchange Bank (¶2 of each note) expressly provide that they are senior to all obligations of Weis to other subordinated creditors -- except for two other commercial lenders holding notes which

were pari passu.* Any contention that notes having the very same provisions were offered widely to a substantial number of persons is thus clearly without merit.

Moreover, plaintiff Exchange Bank's contention (A130) that certain notes allegedly held by O'Hare International Bank and two associated entities ("O'Hare") are "substantially similar" in terms to the notes held by plaintiff Exchange Bank only further demonstrates plaintiff Exchange Bank's mischaracterization of the pertinent transactions. The O'Hare notes were delivered pursuant to a commercial loan agreement (A133-157) which provided for the establishment of a line of credit (A133, ¶1), for which Weis "agree[d] to pay a commitment fee of 1% on the aggregate commitment of the Lenders" (A135, ¶3). Furthermore, the O'Hare loan agreement --

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* The relevant provision of the notes states as follows:

> "[T]his Note shall not be subordinate to any claims of present or future creditors whose obligations are subordinated to claims of General Creditors, including, but not limited to, obligations of [Weis] to Sol Kittay now or hereafter existing ("Other Subordinated Creditors"), it being intended that this obligation shall (x) be senior to obligations of [Weis] to all Other Subordinated Creditors (including existing and future obligations to Sol Kittay), excepting only existing obligations (but not future obligations) of [Weis] to Fidelity Corporation and Security National Bank, and (y) at least be pari passu with existing obligations of [Weis] to Fidelity Corporation and Security National Bank" (emphasis added)(see, e.g., A34).

the provisions of which allegedly are, according to plaintiff Exchange Bank, "substantially similar to the terms of the notes held by plaintiff [Exchange Bank]" (A. 130) -- incorporates certain acceleration provisions and events of default (A. 141-144) which the applicable rules of the NYSE permit to be included in notes which may be held in most instances by at most ten lenders. See NYSE Rule 325.20(4)(A)(ii), CCH New York Stock Exchange Guide ¶2325.20. It is significant that those provisions in the O'Hare loan agreement were some of the "new provisions" which the NYSE stated "were designed to give banks a way in which to make subordinated loans to member organizations" and whose "features are most likely to be attractive to banks" (see pp. 35-36, supra; Appendix A.).

3. The Rule 325 Factors. -- Other factors relied upon by plaintiff Exchange Bank are directly related to the fact that the Weis loan was made and treated in compliance with NYSE Rule 325. Those factors include the restrictions on transfer and prepayment and the alleged inclusion of the proceeds of the loans within Weis' "net capital" (as that term is defined in Rule 325) (A54-A55, A130 - A132). Plaintiff Exchange Bank's contentions with respect to the Rule 325 factors are without merit. The transfer and prepayment restrictions clearly do nothing to show that the

promissory notes here have the characteristics normally associated with securities. Cf., e.g., United Housing Foundation, Inc. v. Forman, supra, 421 U.S. at 851 ("These shares have none of the characteristics 'that in our commercial world fall within the ordinary concept of a security' ... they are not negotiable; they cannot be pledged or hypothecated"); United States v. Koening, supra, 388 F.Supp. at 714 ("that the notes be hypothecated, assigned, or negotiated" is a factor tending to show that such notes are "securities").*

The inclusion of the loan proceeds within "net capital" -- a term of art used in connection with the computation of the net capital ratio under Rule 325 -- merely follows from the fact of subordination and compliance with the other requirements of Rule 325, and is not a distinct substantive factor bearing on the issue of whether the notes are "securities". Similarly, plaintiff Exchange Bank's emphasis (A131) on the fact that subordinated liabilities appeared on Weis' balance sheets under the caption "Subordinated Liabilities and Stockholders' Equity" adds

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*Signficantly, the NYSE does permit member organizations to issue transferable evidences of subordinate indebtedness, which are referred to in the applicable NYSE rule as "Debt Securities". See NYSE Rule 325.21, CCH New York Stock Exchange Guide ¶2325.21. In contrast, the NYSE rule governing non-transferable instruments having features stated by the NYSE as being "most likely to be attractive to banks" (see Appendix A hereto) refers to the "Loan Agreement". NYSE Rule 325.20, CCH New York Stock Exchange Guide ¶2325.20.

nothing of substance. The applicable NYSE rule (Rule 325.30) provides that subordinated liabilities may be shown on the balance sheet "preceding net worth or capital" (emphasis added), and states that "if desired, the[e] caption [referred to by plaintiff Exchange Bank] may be eliminated". CCH New York Stock Exchange Guide ¶2325.30.

4. The Alleged Motivation Factor. -- Another factor relied upon by plaintiff Exchange Bank was its alleged motive in making the loan to Weis. That motive was, in addition to the prospect of receiving repayment of principal and interest, the expectation that Weis and its customers would use the Tel Aviv branch of plaintiff Exchange Bank as a depository and clearing organization for funds (A53). Plaintiff Exchange Bank's characterization of that expectation as an "investment motive" (A58) is self-serving and erroneous. Plaintiff Exchange Bank's alleged expectation was nothing more than the ordinary expectation of a commercial bank that its loan customers would also use it as a depository for funds, and if that "expectation" were sufficient to constitute an "investment motive", any commercial loan could be easily and facticiously transformed into a purported "investment". The "expectation" alleged here thus is not an "expectation of participating in the profits of the maker-borrower, or of receiving substantial benefits from the maker's success

extrinsic to the direct return on the loan". Thorp Commercial Corp. v. Northgate Industries, Inc., supra., CCH Fed.Sec.L.Rep. ¶94, 929, pp. 97,212 - 97,213.

Conclusion

For the foregoing reasons, the order appealed from should be reversed and the complaint and this action dismissed for lack of subject matter jurisdiction.

Respectfully submitted,

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M. F. Educational Circular No. 381

NEW YORK STOCK EXCHANGE, INC.

Department of Member Firms

August 4, 1972

TO: Managing Partner/Chief Executive Officer

SUBJECT: Amendment of Rules Relating to Subordinated Loans

The Board of Directors of the Exchange has adopted an addition to Rule 325.20(4)(a) to provide for long term subordinated loans to be made to member organizations under conditions different from those presently prescribed in the Rule. A copy of the additional language is attached.

These additional rule provisions are the culmination of many months of exploration and negotiation with banks who have sought a way to become subordinated lenders to member organizations and with the SEC. It is effective immediately.

Under rule amendments adopted last year and effective upon the receipt of a favorable tax ruling (described in detail in Educational Circular No. 377 dated June 2, 1972) all subordinated loans must be made pursuant to standard forms prescribed by the Exchange. The Rule amendment just approved provides an alternate means for member organizations to obtain subordinated loans. The new provisions were designed to give banks a way in which to make subordinated loans to member organizations, and its features are most likely to be attractive to banks.

The principal difference between the new provisions and the existing provisions is that the lender's option to terminate the loan on six months notice has been deleted and in its place may be put a series of "events of acceleration", the occurrence of any one of which terminates the loan. In either case, whether the loan has been terminated by an "event of acceleration" or by the lender giving notice, the member organization is not permitted to repay the loan if, following the repayment, its ratio of aggregate indebtedness to net capital would exceed 1,200%.

The new form of subordinated loan is available only for loans of at least $1 million or an amount equal to 10% of the borrowing member organization's net worth, but in no event less than $50,000. There may be as many as ten lenders, but there is a minimum requirement of at least $50,000 per lender. Not less than 1/2 the principal amount of the loan must be for a stated term of at least four years. In other respects the loan provisions are similar to those embodied in the rule amendments approved last year which were the subject of a favorable tax ruling in June 1972.

Questions concerning this circular should be directed to John Fazio at (212) 623-5247 or William G. Carr at (212) 623-5246.

Appendix A

David D. Huntoon
Associate Director

Att.

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By

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